Güler Sabancı, distinguished Brookings fraternity here, and also students, faculty, friends in Istanbul Sabancı University;

I had been to Sabancı years ago but curiously enough only for a meal. There was a small conference dinner that was organized but it is now good for me to be able to interact long distance with you all. Let me stress that for me this is a great honor to be delivering the Sakıp Sabancı lecture. There are some industrialists who through their, of course, enterprise that you need to be a successful industrialist but moral, courage, convictions can play a role in steering a nation. Sakıp Sabancı was a person of great stature. He played a major role along those lines that have been similar characters in the country where we stand. I can think of my country India. There are similar characters who have played a major role. And once again thank you very much for Kemal, from whom I got the first invitation, Kemal Derviş, for the invitation to give this lecture. Thank you very much.

We live in interesting times. As ….(1:22) and I were walking he was saying "the burdens of living in interesting times", which is true that these are risky times. News, composing at a pace that is alarming. A news which is occasionally up and off lit. More frequently the news of downs keep pouring in.

What's happening? And that's where I want to pitch my lecture. It's about the changing structure and nature of the social world. What's happened over, I would say, the last fifty years is perhaps the most dramatic change in the social world – "social" I use broadly to include economics, politics and society – than maybe ever before. In particular, economic globalization has gone on, almost hand in hand with politics and decision making, remaining balkanized and fragmented. This strange combination of balkanized politics and globalized economics has given rise to tensions, challenges of a kind that we have not seen before.

About the globalization – economic globalization – I find the debate on whether it is good or bad pretty futile; because it is similar to debating whether gravity is good or bad. You can tear your head over whether gravity is good or bad, but there isn't very much you can do about that. Globalization is something similar. No one individually plans to have globalization. It is millions and billions of individuals taking their own little decisions, new technology spouting up that has led to globalization. It is a part of life that we have to live with. We can do something about decision-making, which is fragmented, policy-making which is fragmented. And that's where I'm going to focus the lecture, about the policy challenges. And in doing so, I'm going to use a combination of my own background, from completely academic economics to be plunged four years ago into the thick and turmoil of Indian policy-making. And now in the World Bank of a concern with the developing countries, emerging economies all around the world. And I've been arguing in the World Bank that we also ought to be engaged with the industrialized countries, simply because the world cannot be taught off along the partisan lines that we once did.

When I went to India first, to begin on a personal note… When you have discussions at the level of the policy makers, the top bureaucrats sitting in New Delhi… It'll be the same in Istanbul where I had been several times in many different fora… It feels like as if you are in Washington, in London or anywhere else. It's the same language being talked about. The people have broadly been educated in the same places, and really there's very little to distinguish. And I've just been travelling in Africa, in Senegal and South Africa. And once again it's the similar feeling that when you sit with the elites, it's the same newspapers being read, the same journals being read so the language and everything seems similar. So what is different in a developing country in an emerging economy from an industrialized country? For me there was the occasional reminder, dramatic reminder that I was in a totally different setting, completely trivial and I have written about this already but it sort of stands out in my psyches in Delhi. I had once a pest control problem in my home. So I called in a pest control agency. A man came, a Tamil gentleman with lots of cans and syringes, all kinds of chemicals and he started spraying my home and he was working very hard. So I came in asking “You are working very hard but will you get rid of the termite and pest?”. He said with a grind “Sir, have no worries whatsoever. These chemicals are very strong stuff; they are totally banned in the United States.”. You know… By the time he was finishing his sentence I was beginning to edge out of the room. So for him what was a source of comfort, in many places it would be a source of great discomfort. But years have passed now, nothing dreadful happened. So I’m taking that his lack of caution was fine. But small reminders like that would come every now and then that we live in a very very different economy. I would, for instance, when doing my Indian job – this could happen anywhere; this could happen in the US – people’s understanding of the economy, who does what is still very very rudimentary. I would occasionally get a phone call from an aunt in Calcutta, saying that “Prices have gone up once again. What is it that you’re doing?”. So they would go to the market and find that the fish prices have gone up. And there is a presumption that as someone sitting in Delhi, you can manage it all. So that fretting, which actually you see here as if a few people are managing this and causing this is everywhere, which makes it important to bring a lot of professional knowledge into the management of the economy. This does create difficulties, I should tell you, a difficulty and an element of suspicion, which you will see in the US, which you will see in Turkey, which I saw in India, that for a lot of people it is not possible to understand the intricacies of policy making. And you do worry at times that “Is policy making being hijacked by a small group in their own interest?”. And that’s not impossible. When a small group has specialized knowledge it is possible. But the best guard against that is general education. People have to understand as well as possible some of the intricacies of policy making so that ordinary human beings can be watchdogs about what is happening, what decision is being taken.

I’m going to begin by giving you a very quick glimpse of the changing structure of the global economy and then going to some policy challenges. Let me give you one chart which I’ve been using, which is the BRICS’ economy.

Do you have the…? Okay, I’m going to do it. Yeah…

So you will see over here, the GDP proportion, fraction of the world GDP which is the BRICS countries’ GDP.

Okay. That’s alright.

They are okay in Sabancı. They are doing fine. They are seeing the same chart I’m assuming, right? Yeah, hopefully. Okay. If you are not seeing the same chart, well, then just in two or three you can think of something else when I get back again to talking.

You will see this is quite a dramatic chart. I took the case of BRICS because BRICS countries are being tracked that from somewhere like 15% of global GDP, 15-16 % in 1990, the BRICS constitute today little over 26 %, 27% per cent of global GDP. We are talking of “per cent”. So the share of the hundred a rise of this kind is rarely seen. So in the emerging economies you are seeing a very very dramatic rise. Turkey over the last ten years, I know, has been growing at just short of 5 % - 4.9 % or so - rich for a country which is reasonably well-off (?). I mean 10,000 per capita income, a growth of 4.7, 4.8 % sustained over a ten year period is remarkable performance. Indeed, I remember sitting in India – of course I would be watching industrialized countries all the time because it mattered a lot what was happening in Europe, what was happening in the US – but I was also… We were watching Turkey a lot because I have to say that, to the credit of Turkish policy makers, particularly to the central bank; they've been very creative or experimental. This is a word one usually uses with some caution about a central bank. Central banks are meant to be very traditional but I do this with some appreciation that the Turkish Central Bank has brought in some innovative ideas, made moves that were controversial. They were sort of testing the waters. What better than watch another country test the waters sitting far away and seeing what happens. So Turkey was a country that I used to watch a lot. Especially it's tackling of inflation… And one continues to actually appreciate the fact that it's been a very innovative environment in terms of macroeconomic policy making.

South-South trade… I want to give you a quick glimpse now of the increase of that. Yeah… Here's a picture of South-South trade. And you will see the growth of trade of the southern countries with southern countries. So developing and emerging economies with developing and emerging economies. 1960, just short of 15 % of imports of developing countries would be from developing countries. "Developing" I'm using developing and emerging. And by early 2000 it was just short of 30%. And some recent data crunching by the World Bank shows that between 2010 and 2011 southern countries' imports from southern countries has just crossed 50%. So there is an element of resilience beginning to build up. And I'm going to come on this theme about southern resilience, which is needed in today's troubled world. But I want warn you that it's very easy to begin to think that the resilience is huge which it's not. It's a very inter-connected world. And I'll show you the Lehman crisis which is quite fascinating. It's basically… Think of this is borrowing cost of developing countries' sovereigns. Lehman crisis takes place in the US. And the borrowing cost for developing country governments has shoot up. It's a sign of inter-connected world. Let me give you one example when I was hands on working and this was going to link me up with some very important and interesting intricacies of the inter-connected world. In August 2011, I was still in Delhi doing my previous job as a chief economic adviser to the government, when SNPs downgraded the US. US investment was downgraded by SNPs. I remember the evening when the news came. I was in Delhi and we got the news. And we were wondering what's going to happen. The US economy's going to be rocked a bit. India should be fine in the short run but we will feel the pressures in the long run. But what happened was actually fascinating. Money started flowing into the United States treasuries. So, after SNP's downgrade of US, money was flowing in to US treasuries. So you are seeing this affect in India, you are seeing this in Brazil, you are seeing this in South Africa, even Europe barring Germany is seeing money being pulled out and going to the US treasuries, what has happened? Analyzing that gives you a glimpse of the changing structure of world economy. This is investors looking for safety, and where do you find safety? Well, you want to put in your money into bonds of governments which also have the assurance that the government can pay you back. This means that if there is a weak economy you worry about that, or if you have an economy which may be strong but without its own central bank. You worry about that economy's ability to pay you back. So putting money in US treasuries is safe because you know that the US has access to a central bank. And the last thing the US would want is to default on an international investment that has been made in the US. The central bank, the Fed, is going to step in. This had gone from Europe by this time. There are

European countries which are by any global standard strong global economies but they don't have their own Central banks any more. If you put in money in Spain, France, or Italy when the time comes to pay back they don't have that access any more. Printing money to pay back is not a good idea but it's a last measure if there is central bank that you could get that bank to do it. If you don't have a central bank you don't have assurance. So, money which earlier would have gone in to Europe did not go into Europe, because it's a different Europe: It is a Eurozone with one central bank. I should stress over here I do believe that the Eurozone experiment is the right experiment. It's a right direction to go. Just that when you make such a big deliberate construction of an economic structure, it's not surprising that fault lines will show. Most of the economic practices that you see today in the world have evolved slowly over time. And the forces of evolution have buffeted them, corrected them; so over time the rules that we follow in terms of the management of the economy through evolutionary processes, if not through understanding, have got corrected. And the bad practices have fallen out. Europe was a deliberate construction; it did not have the advantage of a hundred years of evolutionary correction. So it's not surprising that fault lines will show, and fault lines did show. So money rushed into the US at that time. And for the first time we see this happening, the exchange rate in India beginning to move and we realized that globalization has changed the landscape.

Let me turn to one picture I'll show and then I want to move on and do a little bit of without picture.

This is the Eurozone. I like this picture because it illustrates dramatic feature of what happened in the Eurozone and the fault line that I was talking about. I want you to understand this. You'll get an intuitive understanding even without getting into the details.

What I'm tracking here is from 1999 borrowing costs of Eurozone countries. So roughly think of this as sovereign… borrowing costs of sovereigns. On the formation of Eurozone people not only policy-makers, they did not understand… No one properly understood. Even investors treated all the Eurozone countries roughly the same. So you invest money in Spain, you invest money in Germany… The safety of that is the same because now they are one common currency area: the Eurozone. So, borrowing cost of Spain and borrowing cost of Italy and borrowing cost of Germany was the same. In the beginning, if you look at borrowing cost, they are virtually the same from 1990 to roughly 2008. 2008 it dons on people. That yes, the Eurozone is a monetary union but each country can default separately. Spain can default when Germany does not default. So the risk of lending to this country should not be treated as the same. And once that realization came, the borrowing cost suddenly fend out. Some countries would have to pay a huge interest to be able to borrow because people realized they are risky. Others would have to pay a very low interest to be able to borrow because they were not risky. This realization that came in some ways too late because what happened before that was… That because of the lower cost of borrowing from many economies which should have had a higher cost of borrowing, they over-borrowed. So by the time we wake up in 2009, there has been a fiscal profligacy; huge fiscal profligacy on the part of our whole host of countries and now we are grappling with debt. And I do agree that jumping to austerity is not the right way to go. There has been fiscal profligacy in the past. You can see this in the dead GDP ratio. And in terms of many other fiscal indicators - but you have to use a combination of very well crafted policies. So with that, I want to … Where do we stand today and what do we expect to see over the next few years and then I want to turn to a couple of policy challenges. And once again putting those policy challenges from the point of view of the developing countries... You know I… Forecasting such a hazardous task that one hesitates to do that. What will the next two years look like? But let me stick my neck out. In the early

1960's in Calcutta, in an uncle's home there used to be a letter from president Kennedy congratulating this uncle for correctly predicting Kennedy's election victory - the 1960, famous election victory. For correctly forecasting… My uncle used to display it very proudly at his home. And we, the cynical nephews and nieces, believed that the uncle had managed to get that letter from Kennedy by sending an identical letter to Nixon predicting his victory as well so that no matter who won, my uncle would get a letter for his wall. Now that's the strategy that economists tend to use. You hedge your bets by saying so many things that no matter what happens you'll be right. There's another ploy that… Not quite ploy… That some people always predict doom and then sometime when the doom happens of course they've got it right. Or some people always predict a boom and when that happens you've got it right. Let me not do those and let me stick my neck out and try to give you a relatively clear belief and with all the question marks the future has answered. I believe that this crisis-like situation will last for at least another 2 years. And the reason for that belief is that what we are seeing around the world policy moves which are right, but they're not solving anything. The injection of liquidity that you're seeing around the world from Japan, United Stated, Bank of England, Swiss National Bank… All these injections are buying time. The ECB… They are buying time but they are not solving problems. And some of this injection took place in huge doses at the end of 2011 and at the beginning of 2012. 1.3 trillion euros injected… Sorry 1.3 trillion dollars… No 1.3 trillion dollars yes, about 1 trillion euros – I was getting the currencies wrong- injected into banks in Europe which will have to be paid back. Three years down the road, end of 2014, 2015. There is no sign that these are being invested in ways whether a re-payment is going to be easy. So there is a very good chance that there'll have to be one more round of injection at that time to again keep the banks buoyant. So the injection of liquidity that has taken place- if I was at the helm taking these decisions I would do the same- is what had to be done but they have bought us time they have not cured any of the problems. The two big problems that we need to attend to. One is fiscal coordination in Europe, better fiscal coordination in Europe and the other is banking union, a well-structured banking union. We do know that this creates some strange political problems of within Eurozone countries taking one view. And EU countries which are not in the Eurozone taking another view because it will be a united banking union of one group so that attentions (?) we don't know whether that will happen. But there are other policies that we have to go in for to meet this challenge of the current times. Look at the fallout of this for the world of not being able to solve the problem. This injection of liquidity does create certain kinds of problems which Turkey has faced, India has faced, China has faced; it's around the world. There has been generally over the last 3 years if you look at the global economy it's a strange kind of stagflation. It's not stag and flation in the same place. But stag in some places and flation in some places. Most industrialized countries are stagnating. Eurozone is technically in recession so Japan has been stagnant for a very very long time. But developing countries, emerging economies where growth has been extremely buoyant. Turkey: last year's was not good but before that Turkey was growing extremely well for a very long time. India: last year's growth was not good but before India was growing phenomenally well. But all these countries Vietnam, even China are growing well but with a problem of inflation. Earlier what macro-economic policy-makers were doing in emerging economies was that they were responding to the injection of liquidity in the industrialized world by trying to grand the liquidity in emerging economies which was giving rise to strange tension liquidity being injected at one end and being taken out at another end. That policy has begun to change. Most emerging economies are not doing that anymore. You are beginning to see the luring of interest rates, repo rates, call money rates are beginning to go down in emerging economies. So they are not doing what they were doing earlier.

And this is giving rise to a new set of problems. Where should we go from here to solve the global problem? And my interest really is formed from the point of view of emerging economies for the following reason. Industrialized countries -even if they grow slowly- they are rich countries. A slow growth for them is not a dramatic event, accepting the unemployment situation and I will comment on that. If a country like the United Stated, Europe… If they can grow at 2% per annum - which would be considered extremely bad performance for an emerging economy or a developing country - 2% per annum would be very good performance for me that would be moving towards the stable world with a fair amount of employment situation much better. The problem really in developing countries even though they are growing well, they are growing well still with a mass of poverty. In our country like India there is about 30% of the population is below the poverty line. And a poverty line that is drawn very very low. 1.25 dollars per person per day, about 30% of the population is below that line. Sub-Saharan Africa: 48.5 % of the population below that line of 1.25 dollars a day. At times you hear from activists saying that “Why do you draw the poverty line so low?”. Indeed that’s a valid question. But you have to realize that even after you draw it so low you find so much of the population below that line. That is a worrying feature of the world. So the present crisis of the world economy is through the crises brewing in industrialized countries. But it’s our primary focus has to be the developing countries and the low-income countries where the consequence of this even if it’s a tiny growth change the consequence of this can be quite dramatic. What should be the policy moves? I have three suggestions but the third one is slightly technical and I’m going to look at my time and then certainly give you the first two thoughts that I have and the third one I may or may not give you.

First of all I feel that in today’s world the need for macroeconomic policy coordination is greater than ever before. And one fact which I keep pointing to but I think it’s just so very important for us to understand that when in the 17^{th} century these central banks were coming up one after another. Ricks bank in Sweden, Bank of England in 1694 there was an understanding that the single economy ought to have single money creating authority. That’s one domain where you don’t want competition. However, so lots of banks came up around the world. I think there must be more than 200 central banks around the world. “1 nation 1 economy 1 central bank”. But since then something has changed in the global economy which I began with. The globalization in economic softer world means that the world is increasingly becoming like a single economy. I know that there are still lots of restrictions and barriers but capital does flow fairly easily. Goods flow not quite easily. But goods do flow and increasingly and maybe over the last 20 years, last 15 years labor is beginning to flow easily at times when the workers are moving, at times with the job moving to where the workers are sitting… It’s a very united economy the global economy is becoming. But we have created lots of central banks. So the predicament that we are trying to get out of in 17^{th} century one economy and one central bank we are back again in to a situation where you have one economy but lots of central banks because the walls fell off somewhere along the lines. This we are not going to very soon see the creation of a single central bank. The one experiment in Europe has put a bit of a slow down to the process of the single central bank but we do need policy coordination. I think that’s extremely important. Take the current situation. Japan injecting liquidity I have to say I personally believe if you look at the last ten years of the Japanese exchange rate, Japan had to do it. It is a highly overvalued exchange rate which was slowing down the economy and slowing down the world. Japan has made that move with a ‘dustro’ let me say… in terms of injecting liquidity. But what that has resulted in is that others are sitting up. And there will probably be similar moves we are seeing first of all in Japan the latest data coming in is that most economic activity, industrial activity is going up. So injection of liquidity is playing a role. I don't think it's going to play a very long time because other countries are going to make similar moves of injection of liquidity. And yes, each country will talk in terms of boosting domestic demand but this also has implications for the exchange rate every time you're doing that. One thing we do need minimally is cluster of large economies and this includes not just the industrialized economies but must include emerging economies even the poorer but large economies. Their central banks have to come together. And think in terms of a coordinated central bank policy. So that if it could be announced that 20 countries with their 20 central banks sat down and they have laid out the following costs for the global economy for the next three months. In the beginning country X is going to inject liquidity. Then one month later country Y will inject a certain amount of liquidity. The road map gets laid out. I have been told in the World Bank not to name countries so many times so I am staying with X and Y which countries will be given that advices. So Xs taught inject some liquidity and Ys taught to inject some liquidity little bit later. If you can lay out a road map of this kind the speculation that comes with a country unilaterally declaring a policy is going to go down. Also the exchange rate movement that you get if it can be coordinated move the movement on the exchange rate can go down so the creation of later liquidity in your country can take place without that injection of liquidity. Also concerns of carry trade. Today a huge concern... I know Turkey's extremely worried about that. That with these interest rate variations which come with central bank policy variations across the world. It's possible to go and borrow in one country where the interest rate is low. And then use it in a country where the interest rate is higher. You are borrowing at a very low interest rate and using it in a country where interest rate is high. Or even through secondary channels lending it in a country where interest rate is high which means you … (30:59) on the interest rate. India where capital account convertibility is limited, we know that in indirect ways a certain amount of carry trade and interest rate arbitrage takes place. So there is great need for that coordination.

Second policy, which again the whole world needs to put its mind together. The labor problem I feel is going to get worse over time. What we are seeing in the world Michael Spence has done some calculations that the total wage bill as a share of the global GDP is shrinking. So the income that comes through work pure labor, that income is becoming a smaller part of the global GDP pie which means people are now earning money through many other sources. You are earning as profit, you have got a piece of paper which gives you returns, so the labor share is decreasing. This is going to be a long run challenge for the world to do with the shifts and tectonic plates of the world that I was talking about earlier. As the demand for labor goes down in the world the first pressure for this will be felt in industrialized countries where the wages are higher. And you are seeing that pressure so the high unemployments that are being seen around the world Europe is now at 12.1 % unemployment ,US is 7.7% unemployment which does not sound that high but you have to remember that of that 7.7 % unemployed in the US 3 9.5, just short of 40% of those unemployed are long term unemployed which is very unusual in the US. In the US the unemployment is typically of people falling into that and then getting out of it. Whereas now there 40% of the unemployed are long term unemployed. And there are studies which show that you begin to deskill when you're long term unemployed. So when you go back to the labor force you are not quite as effective. I think the labor situation is quite dyer. Part of this comes from the changing structure of the global labor force but a part of this also has to do with policy which can be attended to once again through a little bit of a coordinated special policy intervention. And this is the policy intervention that you need in industrialized countries. When you inject this liquidity in to the industrialized country economy as I just said it will typically go with interest rates going very lower and interest rates are indeed very very low. Interests are high in countries in emerging economies with the carry trade problem which they have to face. But when interest rates go so low think of a firm in the United States or in Europe your capital cost is going down because liquidity is being injected. So tiny calculation changes begin to take place on the margin that labor is relatively more expensive than capital because capital cost has gone down. So the incentive to employ more labor does not take place when there is so much of liquidity injection taking place. That needs to be corrected. Here you have to be very cautious and I don't want to put down anything else a sort of final word how that needs to be corrected. But my view is that when liquidity is being injected through asset purchase which is what typically central banks tend to do. You buy mortgage, back securities or something else, 85 billion dollars per month that for instance United States is doing. One way to begin the correct in the asymmetry in the cost of labor and capital that this gives rise to is to inject a part of this money to make hiring of labor more worthwhile for firms. This has to be a strategic intervention on the marginal cost of borrowing, subsidiary for employment is the direct way to do it on the margin. For a temporary period… If you do it for six months, one year so, of the $ 85 billion dollars being injected part of this being done to get the demand for labor buoyed up. If this can be done in Europe, if this can be done in US, Japan across the world, you will begin to create greater employment. Once you create the greater employment since a part of problem today is a trap. It's an equilibrium in which these economies are cork (?). Once the workers begin to work they will create demand for goods. And that's a much better way to create demands for goods by worker actually going and wanting buy more instead of trying to do it with liquidity, pure liquidity injection. So tilting this in a particular way can do it.

The third topic that I would have talked off is somewhat disjointed so I will not talk about it. It's on the nature of central bank interventions and it has probably to do with a little bit more theory. Since Kemal had first corresponded with me about this topic and I know Kemal's background as a mathematical economists. I had a few pictures to demonstrate how central banks will intervene. But I've just given you a fortes by telling you that I have them with me but I will not present them over here. But with these words let me stop here and I'll be happy to continue through questions, comments or however you want to do it. Thank you very much.